Fundamentals of Income Tax

Fall 1996
Fundamentals of Income Tax

Issues
  - Whether
  - When
  - Who
  - How Much
  - Character
Each Issue Has Many Sub-Issues

Issues

Character

Who

Amount Realized

Basis

1041

Challenges

Accreditation Income Doctrine

Accreditation

Deemed

Recapture

Capital

Ordinary

1231

Assignment of Income Doctrine

Deferral

Acceleration

Other

Installment

Cash

Decedents

Heirs

When

Why

How Much
Whether You Have Income or a Deduction is Just the First Step

Whether

Income

- Recognized
- Not Recognized
- Excluded
- Allowed
- Disallowed

Deductions
All Income is Recognized, but Some is Not Recognized (and Thus Deferred), or Even Excluded

- Income
  - Recognized
    - Glenshaw Glass - ATWCR
    - Reginald Turner - Pers. FMV
  - Not Recognized
    - 1031
    - 1033
    - 1034
    - 1041
  - Excluded
Many Sections Provide Non Recognition Treatment
We Examine Four of Them

Such Sections Merely Defer Income

Not Recognized

Factors
- Basis
- Boot

Deferred
- 45 days
- 180 day

1031
1033
1034
1041
Section 1031 Results in Non-Recognition

For Gains and Losses

Factors

Basis

Old Basis Plus Recognized plus Cash Paid Plus Liabilities Assumed Minus Loss Recognized Minus Cash Received Minus Liabilities Relieved

Gain to the Extent

Offset Liability Relieved by Liability Assumed or Cash Paid

45 days

Deferred

180 days
Section 1031 Has Three Factors

For Gains and Losses

Factors

Exchange

Productive Use or Investment

Like Kind
Section 1031(d) Provides the Basis Rule

For Property Received

Basis

Old Basis Plus Gain Recognized plus Cash Paid Plus Liabilities Assumed Minus Loss Recognized Minus Cash Received Minus Liabilities Relieved

Allocate Between Property Received
The Receipt of Boot Triggers Special Rules

Read the Regs Carefully

- Gain to the Extent of Boot
- Offset Liability Relieved by Liability Assumed or Cash Paid
- Cash Received is Never Offset: 1.1031(d)-2 Ex. 2(b)
Deferred Exchanges Are Permitted by Section 1031(a)(3)

With Two Critical Restrictions

Deferred

45 days to Identify

180 days to Complete

Elective
1033 Provides Non Recognition For Involuntary Conversions

Make Sure You Elect in Time

- Destruction, Theft, or Condemnation
- Similar Use Property (Sometimes Like Kind)
  - 2 Year Period
    - Elective
    - Basis Rule
1034 Provides Non Recognition on Sale of Principal Residence

Must Spend at Least Sale Price of Old Residence

- Principal Residence
  - Two year Period Before or After
  - Special Spouse Rules
  - Basis Rule
  - Elective
1041 provides nonrecognition between spouses

- Transfer of “Property”
  - Between Spouses or Incident to Divorce
    - Treated as Gift
      - Carryover Basis
Remember: Recognized Income May Be Excluded
Many Sections Exclude Income
Be Careful With Technicalities

- 71 -- Alimony
- 101 - Death Benefits
- 102 - Gifts and Inheritance
- 103 - State and Local Bonds
- 104 - Personal Injury
- 105 - Health Insurance
- 108 - Discharge of Debt
- 111 - Tax Benefit Exclusion
- 117 - Scholarships
- 119 - Meals and Lodging
- 121 - Over 55 Residence
- 132 - Fringe Benefits
Alimony Exclusion Has Many Factors
Although Styled as an “Inclusion” Section, It Really Excludes: Only Section 61 Includes

- Paid
- Cash
- Spouse or Former
- Pursuant to Instrument
- Not Designated
- If Divorce or Separate Maintenance, not same Household
- No After Death Liability
Section 108 Excludes Income From Debt Discharge in Some Circumstances

But With a Cost: Loss of Tax Attributes
Remember, Whether is the First Step
Focus on Deductions Now
Deductions are Allowed by Many Sections
Read Them Strictly

Allowed

162
163
164
165
166
167/168
212
Section 162 Has Important Sub-Factors

162

- Ordinary and Necessary
- Trade or Business
- Paid or Incurred
- Carrying On T/B
Section 163 Can Be Tricky, Too
It Allows Interest Deductions, but Disallows Much

- Interest Paid or Accrued
- 163(d) limit on Investment Interest
- 163(h) disallowance of personal interest
163(h) Has Exceptions for Qualified Residence Interest

- Personal Int. Disallowed
- Qualified Residence Int. Allowed
- Acquisition Debt
- Home Equity Debt
165 Losses

(a) generally all allowed

(g) worthless securities
   S/E last day of year

(c) individual limits
   T/B
   trans. For profit
   casualty or theft
   - > $100
   - > 10% AGI
212 Deductions

Ordinary and Necessary

(1) Prod. Or Collection of Income

(2) Mgt. Prop. For PI

(3) tax advice
166 Bad Debts

(a)(1) Wholly Worthless: ordinary

(a)(2) Partially Worthless: ordinary

(d) Non Business: STKL
Allowed Deductions May Be Disallowed

- 262 -- Personal
- 265 -- Attributable to Tax Exempt Income
- 267 -- Related Taxpayers
- 274 -- Entertainment
- 280A -- Use of Residence
- 280F - Luxury Autos and Listed Property
- 280G -- Golden Parachutes
Other Deductions are Deferred

- 267(a)(2) - Related TPs
- 263 - Capitalization
- 465 - At Risk
- 469 - Passive Activities
- 461(h) - Economic Performance
Back To The Beginning
Issue Two: When

Issues

Whether

- Cash
- Accrual
- Installment
- Inventory
- Completed Contract

When

Who

How Much

Character
Timing is a Critical Issue

Various Accounting Methods are Permitted

- Cash
- Accrual
- Installment
- Completed Contract
- Inventory
- Carryovers
- Special Rules
When Cash Method Income Exists
Four Theories

- Actual Receipt
  - Cash
  - Property
  - Check (Kahler)
- Constructive Receipt
- Cash Equivalence
- Economic Benefit

Income
Constructive Receipt

- Deferral
  - Cowden (Beginning)
  - Veit (Later)
  - Offer
  - Solvent Payer
    - No Substantial Limitations
    - No Setoff
    - Refusal

- Traditional
Cash Equivalence

- Unconditional
- Promise to Pay
- Solvent Obligor
- No Setoff
- Transferable
- Readily Marketable
- No Substantial Discount
Economic Benefit Doctrine

Economic Benefit

Deferred Comp. Or Contest
Irrevocably Paid
Beyond Reach of Payor’s Creditors
Accrual Method

- Income
  - Earned
  - All Events
  - 461(h)

- Deductions

- Due

- Paid
  - Schlude/AAA
  - Artnell
  - Morgan Guaranty
  - Boise Cascade
  - Coll. Cap/Gown
Carryovers

172 (NOL)

170(d) Charitable

net long against long

net short against short

cross net

up to $3000 against Ordinary income
Special Rules

- Advance/Late Rent
  - Fund. Incons.
  - Erroneous Ded. Ex.
  - 1272-86
  - 483
  - 7872
- Tax Benefit
  - 467
- Time Value of Money
Restoration

Item Prior Included in Gross Income

Appeared Correct

Deduction Allowable

Greater $3000

Established

After Close of Prior Year

TP did not have unrestricted right
1341 Application: tax is lower of:

- (a)(4): take deduction
- (a)(5): no deduction, but credit for tax on the restored item in prior year
Back to Beginning: Step Three
Who

Assignment of Income
7872